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TAGS: ECON EFIN PGOV EINV SOCI PREL BR
SUBJECT: BRAZIL'S 2004 BUDGET BLUES

REF: A) Brasilia 936
B) Brasilia 291
C) Sao Paulo 557
D) Brasilia 661
E) Brasilia 873
F) Brasilia 644
G) Brasilia 1048

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SUMMARY AND COMMENT

¶1. (U) A high debt-service burden and extensive earmarking leave Brazil's federal government with little room for maneuver in its Reals 413 billion (USD 137 billion) 2004 budget as it tries to pursue its social-policy goals while addressing public concerns over security, unemployment and growth. In 2003, overall public-sector interest outlays of 9.48% of GDP turned the GoB's hard-won primary surplus of 4.32% of GDP into a nominal deficit of 5.16%. This year there is some relief on the interest front, as the return of financial-market confidence has reduced rates on Brazilian debt. The GoB estimates interest outlays of about 7.4% of GDP in 2004. Given the GoB's resolute pursuit of a 4.25% of GDP primary surplus, that would cause the projected nominal deficit to fall to about 3.15% of GDP. Discretionary expenditures (program funds and investment outlays) amount to about 13% of all federal outlays, including interest payments and mandated transfers to states and municipalities. The transfers reduce the revenue available to the federal government by 15-16%.

¶2. (U) The GoB's commitment to an austere fiscal policy, even as economic growth remains feeble, has made it the target of sustained criticism. Pressure is building, through a series of strikes and work slowdowns and landless-movement squatter invasions, for larger-than-budgeted public-sector wage increases and additional money for resettlement efforts (refs C and E). Official data shows that, by some measures, President Lula's Workers' Party government spent less on social programs in its first year than its predecessor did the year before.

¶3. (SBU) Despite these pressures, we see no danger of a change in the GoB's commitment to its primary-surplus goal this year: Lula has made defense of his team's economic policy a constant feature in his public appearances. Two April 15 actions reinforced this commitment: the Senate budget committee endorsed the multi-year budget plan, and, separately, Lula sent Congress the 2005 Budget Guidelines Bill, both of which set a 4.25% primary-surplus target for ¶2005. We do expect the GoB to tinker around the edges of the budget in this municipal-election year, including by accelerating the expenditure of some higher-than-projected tax collections from the first quarter of 2004 and finding even more "savings" by cutting expenditures from program budgets. But we believe these adjustments will always be made with the overriding primary surplus goal in sight. END SUMMARY AND COMMENT.

Table I
Public Sector Primary Surplus Breakdown
(Percent of GDP)

	2003	2004
Federal Government	4.17%	4.18%
Social Security	-1.74%	-1.73%
State Governments	1.89%	1.80%
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Public Sector Primary Surplus	4.32%	4.25%

- Public Sector Interest Payments/1	9.48%	7.4%
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Nominal Deficit	5.16	3.15

Sources: Central Bank, Ministries of Planning and Budget, Finance

/1 Note: Central Bank Chairman Meirelles in public comments April 29 estimated that 2004 interest outlays could be as low as 7.15% of GDP.

Budget Outline

¶4. (U) Brazil's federal government collects 23% to 24% of GDP at the federal level. About two-thirds of this (16.23% of GDP) is projected in 2004 to come from taxes and "contributions," the largest of which are personal and corporate income taxes (5.1% of GDP), COFINS (a payroll contribution whose revenues, at 4.3% of GDP, are earmarked for social-security expenditures) and the CPMF, a financial transactions "contribution" (1.5% of GDP). The remaining one-third is made up of private sector social-security contributions (at 5.48% of GDP) and of other income (2.25% of GDP, including dividends from parastatals, fees, royalties, and worker unemployment insurance fund payments. "Importation Taxes," i.e., tariffs, are projected at Reals 9.2 billion or 0.54% of GDP for 2004).

¶5. (U) A constitutional revenue-sharing scheme mandates the transfer of 47% of all personal and corporate income taxes and 57% of the federal Industrial Production Tax (the "IPI") to states and municipalities. In recent years these transfers have reduced overall federal income by about 15%-16%. They have also given the federal government an incentive to create a series of "contributions," which, unlike "taxes," are exempt from the constitutionally-mandated transfer arrangements. After transfers, net federal income (including social security contributions) currently fluctuates around 20% of GDP. Brazil's total tax burden, once state and municipal taxes (notably the ICMS) are added in, was over 36% of GDP in 2003.

Table II
Federal Income
Billions of Reals (Nominal)

	2002 Executed	2003 Executed	2004 Law	2004 After Sequestration
Total Income	324.02	359.98	413.47	407.14
- % of GDP	24.1%	23.8%	24.9%	24.5%
- of which taxes	224.27	247.18	279.92	274.90
- other income	27.29	31.01	39.72	38.12
- Worker Guarantee Fund Income	1.92	1.67	1.57	1.57
Social Security Contributions	71.03	80.12	92.58	92.82
Transfers to States and Municipalities	52.28	56.86	64.27	61.50
- % of GDP	3.88%	3.75%	3.87%	3.70%
Net Federal Income	271.74	303.13	349.19	345.64
- % of GDP	20.19%	20.00%	21.00%	20.79%

Source: Ministry of Planning and Budget

¶6. (U) To meet their primary-surplus goals, GoBs of recent years have limited non-debt-interest federal expenditures to between 17% and 18% of GDP. The Lula government cut such expenditures in its first year, 2003, to 17.53% of GDP from 17.83% of GDP in 2002. It projects a rise to 18.3% of GDP in 2004 (Tables I - III). Almost 87% of federal spending, including federal-level interest payments and transfers to the states and municipalities, is earmarked or otherwise not discretionary, i.e. committed to salaries and benefits. Salaries and benefits (including pensions for government employees) have swallowed as much as 30.85% of non-interest expenditures in recent years.

¶7. (U) Constitutional and legislative earmarking leaves the federal government insufficient money to make interest payments on the debt and for required program expenditures and investment. In addition to the mandatory transfers to states, income from many taxes is earmarked. Revenues from "contributions," which are taxes in all but name, are 100% earmarked. Income from the CPMF, for example, which hits financial transactions, legally is required to be spent for Social Security, the Combat Against Poverty Fund, and health programs. The solution to this budgetary Gordian knot was a legislative/budgetary artifice, the so-called "DRU," that de-links 20% of federal tax and contribution receipts (after the required transfers to states) from the earmark

calculation. This gives the GoB some margin to cover interest payments, wages and benefits and have a little money left over for discretionary expenditures. To obtain original passage of the measure in the early 1990s, it was made nominally temporary; in December 2003 Lula's GoB achieved its latest extension, this time through 2007.

¶8. (U) After making wage and benefit payments, social security payments and other obligatory expenditures (and having netted out interest payments and transfers to the states) the GoB is left with between 20% and 22% of its expenditures to allocate at its discretion among ministries to cover program expenses (utilities, travel costs, etc) and investment (everything from computer upgrades at ministries to selected infrastructure projects - see Table III). (Note: Discretionary expenditures are about 13% of federal outlays if interest payments and transfers to states are included in the calculation.) It is this discretionary portion of the budget which invariably is sequestered to meet primary-surplus goals. There are limits on how much the GoB can try to save on these program expenses; the savings effort last year at times left some ministries struggling to pay their electricity bills. In early 2003, Lula's then-incoming GoB cut these discretionary expenditures by over Reals 4 billion in nominal terms from 2002, primarily by cutting investment outlays (see Table III).

Table III
Federal Expenditures, Primary Surplus
and Social Security Deficit
Billions of Reals (Nominal)

	2002 Executed	2003 Executed	2004 Law	2004 After Sequestration
¶I. Expenditures	240.00	265.54	307.35	304.22
- % of GDP	17.83%	17.53%	18.48%	18.30%
a) Salaries and Government Benefits, including Pensions	74.04	78.97	83.70	84.71
- % of expenditures	30.85%	29.74%	27.23%	27.84%
- % of GDP	5.50%	5.21%	5.03%	5.09%
b) Private Sector Social Security Benefits	88.03	107.13	122.19	122.05
- % of expenditures	36.68%	40.35%	39.76%	40.12%
- % of GDP	6.54%	7.07%	7.35%	7.34%
c) Other Obligatory Expenditures	21.81	27.37	30.92	32.23
- % of expenditures	9.09%	10.31%	10.06%	10.60%
- % of GDP	1.62%	1.81%	1.86%	1.94%
d) Discretionary Expenditures	56.12	52.06	70.54	65.23
- % of expenditures	23.38%	19.61%	22.95%	21.44%
- % of GDP	4.17%	3.44%	4.24%	3.92%
II. Primary Surplus (without Social Security)	48.74	64.60	71.46	70.64
- % of GDP	3.62%	4.26%	4.30%	4.25%
Social Security Deficit	-17.00	-26.40	-29.62	-29.23
- % of GDP	-1.26%	-1.74%	-1.78%	-1.76%
Overall Federal Primary Surplus /1	31.92	38.74	41.85	41.42
- % of GDP	2.37%	2.56%	2.52%	2.49%

1/ State-level savings and earnings from financial parastatals, not included here, increase the overall public sector primary surplus (see Table I).

Source: Ministry of Planning and Budget

2004 Expenditure Tensions

¶9. (U) The Lula administration, under the authority of the Fiscal Responsibility Law (LRF), started 2004 by freezing Reals 6.6 billion in expenditures from the 2004 budget law approved previously by Congress. This was a GoB step to re-assert revenue realities (Ref B). The Congress had adopted a series of optimistic revenue assumptions, including real GDP growth of 4% (versus 3.51% in the administration budget proposal) to justify the increased spending, most of which would have gone to finance pork-barrel investment (ref A). To soften the political impact of its spending freeze, the GoB said at the time that it would contemplate unfreezing some expenditures relatively early in the year, should revenues be higher than it projected.

¶10. (U) Revenues through March have in fact been running ahead of projections: Ministry of Finance data show first-

quarter federal revenues at Reals 75.3 billion, up 13.9% from the same period of 2003. This represents a real increase of about 7.7% (deflating using the IGP-DI, a broad inflation index). This resulted in a first-quarter 2004 primary surplus of Reals 20.3 billion, well ahead of the Reals 14.5 billion target, despite having to offset an unexpectedly negative income of Reals 2.2 billion from parastatals (mostly accounted for by Petrobras dividend payments). By comparison, the first-quarter surplus in 2003 was Reals 22.8 billion, with parastatals contributing Reals 3.2 billion to the positive outcome. This implies a large positive swing in the federal-level surplus.

Wages and Strikes

¶11. (U) The GoB set aside Reals 1.5 billion in the 2004 budget to accommodate projected wage increases for public-sector workers ranging from 7.1% to 29.4% (depending on the job category). Under the threat of a general strike by government workers (Ref C), the GoB has improved its offer to the 9.5% to 32.3% range, an action that reportedly would increase the fiscal impact of the wage settlement by 500 million Reals, for a total fiscal impact of about 2 billion Reals. This new offer comes after the GoB's announcement of Reals 1.7 billion for the resettlement of landless movement (MST) families (ref E), an amount also not accounted for in the original GoB budget proposal. These increased expenditures will need to be offset through reduced investment, greater savings in program expenses, and/or using some of the greater-than-anticipated revenues from the first quarter, which the GoB originally planned to hold in reserve until later in the year (ref B).

¶12. (U) Refs A and G reports on Lula's oft-delayed decision, originally expected April 15, on the size of this year's increase in the minimum wage. Explaining the delay, Lula told reporters that he needed to weigh carefully the social implications of the size of the minimum-wage increase against the need to invest to facilitate future economic growth, implying that the latter would have to be reduced to offset higher-than-planned wage expenditures. Despite substantial pressure for a significant increase, in the event Lula raised the minimum wage by 1.2% in real terms (Reals 20), to Reals 260. When coupled with a parallel increase in a social assistance payment, the 20-Reals increase should add Reals 677.7 million in expenditures beyond those envisioned in the 2004 budget document during the remainder of this calendar year. This remains well within the budgetary cushion that higher-than-anticipated revenues have won the GoB.

Investments

¶13. (U) The easiest target of cuts have been discretionary investment expenditures. When it first came into office in January 2003, the Lula administration cut investment expenditures in nominal terms from the Reals 10.9 billion in the last year of the FHC administration to Reals 6.957 billion in 2003 (an even more substantial cut in real terms). And, while the Congress budgeted investment expenditures at Reals 12.9 billion for 2004, the GoB's freezing of expenditures cut that by almost Reals 6 billion. Through March 2004, only Reals 54.8 million in investments had been executed, Reals 47.4 million of which was by the Air Force. This inability to finance substantial investment, particularly infrastructure investment, at the federal level increases the importance of Brazil's effort to attract investment to infrastructure projects through Public Private Partnerships (PPPs - Ref F).

Table IV
Federal Budget By Function
Billions of Reals

	2002 Executed	2003 Executed	2004 Law
Pensions (public & private)	123.22	145.48	160.71
- % of Expenditures	51.3%	55.4%	52.4%
Sanitation	0.097	0.06	0.19
- % of Expenditures	0.04%	0.02%	0.06%
Health	25.43	27.17	33.10
- % of Expenditures	10.6%	10.4%	10.8%
Public Security	2.20	2.41	2.72
- % of Expenditures	0.92%	0.92%	0.89%
Education	13.22	14.22	13.85
- % of Expenditures	5.5%	5.4%	4.5%
Defense	12.62	11.57	11.95

- % of Expenditures	5.3%	4.4%	3.9%
Social Programs	6.51	8.42	13.17
- % of Expenditures	2.7%	3.2%	4.3%

Source: Ministry of Planning and Budget

Social Programs

¶14. (U) Lula's PT government has come in for considerable criticism over the low level of spending on social programs. There is some official data to indicate that Lula spent less on social programs in the first year of his administration than his predecessor Fernando Henrique Cardoso (FHC) did in 2002, his last. There was a decrease in nominal terms of the budget of the Social Assistance Ministry, which fell from Reals 1.2 billion in 2002 to Reals 1.0 billion in 2003. The GoB, however, claims an increase in social expenditures, from Reals 6.5 billion to Reals 8.4 billion, based on more inclusive measures of social-assistance programs scattered through many ministries. By this measure, social spending increased 18% in real terms as well as increasing as a percent of GoB expenditures (to 3.2% from 2.7% in 2002). The Congress budgeted a much larger increase, to Reals 13.2 billion for 2004, representing 4.2% of expenditure, in part as financing for a new secretariat to manage hunger alleviation programs, including the Bolsa Familia program (Table IV).

Public Security

¶15. (U) Polling data have consistently shown that the poor public-security situation is the area of greatest public dissatisfaction with the GoB's record. While the state governments carry the main responsibility for public security and much of the expenditure burden, the perception of governmental inaction taints all levels of government. Federal public security expenditures have in fact increased slightly in real terms since the last year of the Cardoso government, and are budgeted to do so again in 2004. However, public-security spending still accounts for less than 1% of the federal budget and stands to decline slightly as a percent of expenditures inn the 2004 budget (Table IV).

Industrial Policy

¶16. (U) The GoB's splashy March 31 announcement of amounts to be spent on its industrial policy caused some market and media concern that this spending might endanger the GoB's 2004 budget target. The monies involved, however, are mainly earmarks for sector-specific lending by the Economic and Social Development Bank (BNDES) and majority state-owned Banco do Brasil. Out of BNDES' total 2004 lending target of Reals 15.05 billion for industrial development, the industrial policy earmarks Reals 3.61 billion for the software, pharmaceuticals, capital goods and microelectronics sectors. The money is supposed to be destined primarily for modernizing plant and equipment in these capital-intensive sectors (ref D). A further Reals 550 million is slated to come from the 2004 budget to create research and development incentives, including by increasing staff at Brazil's Intellectual Property Institute (INPI) to ensure patent applications are given quicker handling.

Military Expenditures

¶17. (U) Brazil's defense budget (excluding pensions and benefits) fell in nominal terms from Reals 12.6 billion (0.94% of GDP or 5.26% of federal expenditures after state transfers and interest payments are netted out) in 2002 to Reals 11.6 billion (0.76% of GDP) in 2003, representing 4.41% of expenditures. While Congress subsequently budgeted defense expenditures to increase to Reals 11.95 billion in 2004, this would still represent a reduction to 3.9% of federal non-interest expenditures and a fall to 0.72% of projected GDP.

¶18. (U) The biggest question mark on military expenditures is the much-postponed decision on the purchase of new fighter aircraft to replace Brazil's aging fleet of Mirage 2000's. Many of the financing plans presented by the competing consortia have a grace period before repayments begin, so these expenditures may well not figure in this year's budget even if the GoB were to sign a contract, which seems most unlikely. On the other hand, payments for Lula's new Airbus ACJ reportedly are to come out of the Air Force budget beginning this year. Although the Airbus financing plan for the $56.7 million plane was not detailed in the budget document, one media account said that an initial $1 million would be due upon contract signature, followed by a $15.2 million (about Reals 45.6 million) payment later this year, out of an Air Force 2004 equipment budget in the 2004

budget law approved by Congress of Reals 213 million.

Social Security Deficits

¶19. (U) Aside from payments on the existing public-debt stock, the biggest looming threat to GoB budgetary health comes from the private-sector social security pension system (INSS). While Lula's public-sector pension reforms last year should help "staunch the bleeding" in the public-sector pension system, keeping the deficit in this part of the system relatively constant at 3% - 3.5% of GDP for the next several years, the INSS system covering the private sector is a different story. Contributions into that system are not keeping pace with benefit payments. The INSS deficit widened from 1.26% of GDP in 2002 to 1.74% of GDP in 2003 and preliminary reports for 2004 suggest the deficit continues to widen well beyond the 1.76% of GDP deficit the GoB projected. Analysts predict that this growing deficit over the medium run will more than offset the savings attained in the public-sector pension reform of 2003 (Refs A and G). An idea of the scale of the issue can be gleaned from the fact that the INSS (private-sector) pensions are expected to account for 40% of federal non-interest expenditures in 2004 (Table II). While these expenditures are offset in part by contributions, covering the deficit will consume 9.6% of federal non-interest outlays.

COMMENT

¶20. (SBU) Lula is personally committed to the primary surplus goal and gives all the signs of being more than ever convinced that current tight monetary and fiscal policies are necessary to set the stage for sustained growth. Questioned by a recent interviewer whether he is committed to this year's primary-surplus target of 4.25%, his exasperation-tinged response was: "It won't change, it won't change, it won't change!" Nevertheless, the GoB is under substantial pressure to increase expenditures, and it has begun to accommodate these demands at the margins. Better-than-expected revenues in the first quarter make this possible without vitiating the primary-surplus target, but the GoB originally had planned to hold any higher-than-expected revenues in reserve. Should the current positive revenue trend not be borne out for the full year, the GoB would have to sequester more program spending. Investment expenditures likely would suffer even more under that scenario. All of this reinforces the importance of the GoB attracting private investments in infrastructure.

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